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1985 Dodge/Sweet's Construction Outlook

Second Update
July 1985

Revival In 1985

After stalling in 1984, the building market is expanding again.

The sideways movement of the Dodge Index of construction contracting through 1984 strongly suggested that after two years of expansion, the upper limit had been reached. Between 1982:II and 1984.I the Index rose from a depressed 103 to 148, but by 1984:IV it was no higher than 149. Then, like a whiff of oxygen to a tired athlete, falling interest rates revived the market. Contracting advanced 5 percent in 1985's first quarter (to a new high of 152), and was doing even better in the second (a very possible 160 in the making).

At mid-1985, the outlook for the remainder of the year is a mixture of promise and concern. The promise of still lower interest rates by year-end implies continued improvement in the reviving residential building market. The cause for concern arises out of the very reason why interest rates are being nudged down—to counteract deep-seated problems in the economy's industrial sector. With falling interest rates as the catalyst, 1985's gains in housing are coming at the expense of commercial and industrial building.

The Case For Lower Mortgage Rates

The economy clearly needs lower interest rates to restore its growth. The hard dollar (a side effect of high interest rates since the early 1980's) is seriously inhibiting industrial expansion, and business capital spending is faltering. The opportunity for monetary stimulus is also available. Inflation is dormant, and the Administration and Congress are finally coming to grips with the deficit. There are no credible arguments left for maintaining artificially high interest rates, and there is every reason for the Fed to lean in the direction of monetary ease for as long as the economy needs support. That need could linger throughout most or all of 1986.

The Federal Reserve's timely cut of its discount rate in May left little doubt as to the intent of current monetary policy and cleared the way for *continued* decline of long-term interest rates during the second half of 1985. Prior to the latest easing, it appeared that mortgage rates would be settling in the range of 12.50 to 12.75 percent this year, down from 1984's third quarter peak of 14.11 percent. Now, with the Fed's encouragement, it is reasonable to look for 12.0 percent mortgage money (maybe lower) by the end of 1985, with little upward pressure in 1986. *The implication: an already favorable housing outlook becomes even better.*

The Drag Of Growth Recession

A recent study by Data Resources, Inc. offers some dimensions of the impact that the dollar's appreciation since 1980 is having on the economy's industrial sector. Export sales are approximately 15 percent lower, and imports 15 percent higher, than if former exchange rates still prevailed. This translates into a reduction of nearly 10 percent in industrial output, and a loss of roughly 2 million production jobs.

The handicap of a large trade deficit will persist in retarding real GNP growth as long as the overvalued dollar makes imported goods attractive to consumers. Even with the help of monetary stimulus, it will take the rest of 1985 and most of 1986 to revive the economy from its lapse into "growth recession." As a result, a period of subnormal GNP growth (2 to 3 percent in constant dollars) must be endured before the more desirable 3.5 to 4 percent rate is restored. For this year's second half, growth is estimated at between 2.5 and 2.75 percent—not much different from the first half rate.

Because the term "growth recession" literally means insufficient economic expansion to absorb excess capacity (whether labor or plant and equipment),

the outlook for business capital spending has deteriorated since the rate of capacity utilization began slipping back toward 80 percent. *The implication: a setback for the commercial and industrial building sector.*

Housing Outlook

The turnaround of the housing market early in 1985 was, of course, the main thrust behind this year's renewed advance of construction contracting. By May, the rate of residential starts had topped $100 billion for three consecutive months, regaining a level that had not been reached since early in 1984.

The revival of housing activity since the end of 1984 has been dominated by the multi-family side of the market which delivered 100,000 of the 150,000 unit improvement to date. The second half of 1985 should belong to single-family housing, which still has a lot of catching up to do.

Single-family Housing: Based on recent experience, by the time the "standard" mortgage rate winds down to 12 percent (tentatively 1985:IV), the rate of one-family housing starts should be approaching 1,150,000 units (F.W. Dodge basis*). Through mid-1985, however, the response by homebuilders and buyers has been something less than recent experience would lead you to expect. With mortgage money now getting close to 12.5 percent (down from last year's 14 percent), one-family starts ought to be comfortably above 1.0 million units instead of struggling to reach 975,000.

It is not hard to rationalize the shortfall. Buyers could be responding to lower mortgage rates, by substituting condos (i.e., multi-family units) for singles. Buyers probably expect rates to go still lower, and may be holding back awhile longer. Buyers might feel insecure due to the threat of recession.

Any of these reasons could explain a delayed response to the improving credit environment, but in time, lower mortgage cost will generate more one-family demand. An annualized rate of 1,150,000 starts remains a good probability by 1985:IV, but due to sluggish response during the middle quarters of the year, 1985's total is not likely to exceed 1,040,000 one-family units.

If 1986 begins where 1985 ends, and if mortgage rates hold steady as expected, next year's one-family building volume should be closer to 1.1 million units.

Multi-family Housing: A very strong 750,000 unit rate of apartment and condominium starts in 1985's second quarter requires a further upgrading of 1985's full year potential to a total of 735,000 units.*

A rate of building this high is considered to be at least 100,000 units above basic demographic requirements for multi-family housing, as evidenced by the rising vacancy rate. Like offices, apartments have been overdeveloped since ERTA's accelerated depreciation provision offered a highly attractive tax

*The total number of newly started dwelling units reported by F.W. Dodge covers virtually the same universe as the U.S. Commerce Department's data. However, due to definitional differences in the part of the housing market that takes in townhouses, condominiums, and other newer forms of housing which do not fit neatly into traditional stereotypes, Dodge data typically show a higher proportion of multi-family units than Commerce does, and correspondingly fewer one-family units.

1985 National Estimates
Dodge Construction Potentials

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		1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings				
Floor Area (millions of square feet)	Office Buildings	318	295	– 7
	Stores & Other Commercial	478	531	+11
	Manufacturing Buildings	144	142	– 1
	Total Commercial & Manufacturing	940	968	+ 3
	Educational	90	95	+ 6
	Hospital & Health	70	71	+ 1
	Other Nonresidential Buildings	122	131	+ 7
	Total Institutional & Other	282	297	+ 5
	Total Nonresidential Buildings	1,222	1,265	+ 4
Contract Value (millions of dollars)	Office Buildings	$ 23,035	$ 22,025	– 4
	Stores & Other Commercial	18,496	20,925	+13
	Manufacturing Buildings	7,163	7,150	—
	Total Commercial & Manufacturing	$ 48,694	$ 50,100	+ 3
	Educational	$ 7,588	$ 8,300	+ 9
	Hospital & Health	7,128	7,500	+ 5
	Other Nonresidential Buildings	9,948	10,500	+ 6
	Total Institutional & Other	$ 24,664	$ 26,300	+ 7
	Total Nonresidential Buildings	$ 73,358	$ 76,400	+ 4
Residential Buildings				
Dwelling Units* (thousands of units)	One-Family Houses	994	1,040	+ 5
	Multi-Family Housing	759	735	– 3
	Total Housekeeping Residential	1,753	1,775	+ 1
Floor Area (millions of square feet)	One-Family Houses	1,567	1,632	+ 4
	Multi-Family Housing	725	701	– 3
	Nonhousekeeping Residential	90	88	– 2
	Total Residential Buildings	2,382	2,421	+ 2
Contract Value (millions of dollars)	One-Family Houses	$ 66,526	$ 72,850	+10
	Multi-Family Housing	27,973	28,400	+ 2
	Nonhousekeeping Residential	6,325	6,350	—
	Total Residential Buildings	$100,824	$107,600	+ 7
Nonbuilding Construction				
Contract Value (millions of dollars)	Highways & Bridges	$ 17,075	$ 18,600	+ 9
	Sewer & Water	8,079	8,700	+ 8
	Other Public Works	8,135	8,400	+ 3
	Total Public Works	$ 33,289	$ 35,700	+ 7
	Utilities	$ 2,518	$ 2,500	– 1
	Total Nonbuilding Construction	$ 35,807	$ 38,200	+ 7
All Construction				
Contract Value (millions of dollars)	Total Construction	$209,989	$222,200	+ 6
	Dodge Index (1977 = 100)	149	158	

*F.W. Dodge basis.

1985 Regional Estimates
Dodge Construction Potentials

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Northeast — CT, ME, MA, NH, NJ, NY, PA, RI, VT

Contract Value (millions of dollars)

	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$ 8,286	$ 8,350	+ 1
Institutional and Other	4,447	4,925	+11
Total	$12,733	$13,275	+ 4
Residential Buildings			
One-Family Houses	$ 8,683	$10,575	+22
Multi-Family Housing	3,596	3,875	+ 8
Nonhousekeeping Residential	847	850	—
Total	$13,126	$15,300	+17
Nonbuilding Construction			
Highways and Bridges	$ 3,216	$ 3,250	+ 1
Other Public Works	3,120	3,350	+ 7
Utilities	316	300	− 5
Total	$ 6,652	$ 6,900	+ 4
Total Construction	$32,511	$35,475	+ 9

South — AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV

Contract Value (millions of dollars)

	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$18,520	$19,575	+ 6
Institutional and Other	9,425	9,650	+ 2
Total	$27,945	$29,225	+ 5
Residential Buildings			
One-Family Houses	$30,301	$32,000	+ 6
Multi-Family Housing	12,611	12,125	− 4
Nonhousekeeping Residential	2,666	2,800	+ 5
Total	$45,578	$46,925	+ 3
Nonbuilding Construction			
Highways and Bridges	$ 6,086	$ 6,875	+13
Other Public Works	5,826	6,275	+ 8
Utilities	1,416	1,200	−15
Total	$13,328	$14,350	+ 8
Total Construction	$86,851	$90,500	+ 4

North Central — IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI

Contract Value (millions of dollars)

	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$ 9,433	$ 9,525	+ 1
Institutional and Other	5,095	5,525	+ 8
Total	$14,528	$15,050	+ 4
Residential Buildings			
One-Family Houses	$10,493	$11,500	+10
Multi-Family Housing	3,585	3,775	+ 5
Nonhousekeeping Residential	930	825	−11
Total	$15,008	$16,100	+ 7
Nonbuilding Construction			
Highways and Bridges	$ 4,735	$ 5,225	+10
Other Public Works	3,668	3,700	+ 1
Utilities	208	250	+20
Total	$ 8,631	$ 9,175	+ 6
Total Construction	$38,167	$40,325	+ 6

West — AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY

Contract Value (millions of dollars)

	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$12,455	$12,650	+ 2
Institutional and Other	5,697	6,200	+ 9
Total	$18,152	$18,850	+ 4
Residential Buildings			
One-Family Houses	$17,049	$18,775	+10
Multi-Family Housing	8,181	8,625	+ 5
Nonhousekeeping Residential	1,862	1,875	—
Total	$27,112	$29,275	+ 8
Nonbuilding Construction			
Highways and Bridges	$ 3,018	$ 3,250	+ 8
Other Public Works	3,600	3,775	+ 5
Utilities	578	750	+30
Total	$ 7,196	$ 7,775	+ 8
Total Construction	$52,460	$55,900	+ 7

advantage. The probability that current proposals for tax reform will lead to a lengthening of depreciation in 1986 will have two effects: to encourage excessive building for the balance of 1985, and to precipitate a sharp decline in 1986 when the rules change.

It will take several more months of debate before Congress and the Administration agree on the details of their tax reform program. Meanwhile, the booming apartment building market is headed for another exceptional year in 1985.

Total Residential Building: As single-family building continues to respond to falling interest rates through 1985's second half, the year's dwelling unit total is forecast to reach 1,775,000. The 1985 value of all residential building—including hotels, motels, and dormitories—will total $107.6 billion, a gain of 7 percent over last year.

Nonresidential Outlook

Commercial and Industrial Building: The economy's lapse into "growth recession" since mid-1984 is taking its toll on commercial and industrial building. From a strong 11 percent advance in 1984's first half, contracting eased to a 6 percent gain through last year's second half, and then all but ceased expanding in the first six months of 1985. A mere one percent gain during the most recent

six month period brought the annualized rate of contracting for offices, stores, warehouses, and factories to 982 million square feet—the probable peak of the current cycle. As this sensitive market is subjected to continued stress in the quarters ahead, contracting for commercial and industrial building is expected to decline by 3 percent (to a rate of 950 million square feet) in 1985's second half.

Office building heads the list of vulnerable markets, but as the deadline for tax reform nears, contracting for offices could go either way. Responding more to the laws of taxation than to the law of supply and demand, new office starts again topped 300 million square feet (annual rate) in 1985's first half despite a national vacancy rate well above 15 percent. However, with starts of large, high-rise projects diminishing, it is presumed that the interaction of two conflicting motives—the urge to qualify for 18-year depreciation, and traditional concern about soaring vacancies—will bring the rate of contracting down to about 285 million square feet in the second half (still a lot more than the market can digest). In 1986, a considerably lower rate will be appropriate.

Industrial building, another vulnerable category, may already have made its adjustment to the limitations of the mid-1980's. After a promising recovery in 1983, contracting for manufacturing buildings plateaued in 1984 at 144 million square feet—roughly three-quarters of its potential for expansion. With little prospect that capacity utilization in the manufacturing sector will rise above its current 81 percent in the next 12 to 18 months, contracting for industrial construction appears stalled in the range of 140-145 million square feet through the rest of 1985 and all of 1986 as well.

Contracting for stores, shopping centers, and warehouses is providing a stabilizing influence in the commercial and industrial building market. Linked closely to homebuilding, construction of retail facilities will be averaging a solid 450 million square feet through 1985's second half and into 1986 while residential building benefits from declining mortgage rates.

For the full year 1985, contracting for commercial and industrial building is forecast to reach 968 million square feet, the highest volume achieved since 1979. Construction contract value will advance 3 percent to $50.1 billion.

Institutional Building: The improved flow of revenue to state and local governments and the reduced cost of municipal finance together have greatly improved the outlook for institutional building. A "break-through" was achieved during 1984's second half when the rate of contracting for schools, hospitals, and public administration buildings escalated 10 percent to 300 million square feet for the first time in five years of depressed building. Educational construction delivered most of the rebound.

After a temporary setback in 1985:I, contracting for institutional building appears to be steadying at close to 300 million square feet this year.

Total Nonresidential Building: Coming off its cyclical peak of 1,293 million square feet (1984:IV), contracting for nonresidential building is slackening in 1985 while residential building recovers. Compared with the first quarter rate of 1,280 million square feet, total nonresidential square footage will still be relatively strong at 1,250 million by the final quarter, yielding a full year total of 1,265 million square feet.

The value of 1985's "mix" of commercial, industrial, and institutional contracting is estimated to reach a total of $76.4 billion.

Public Works Outlook

Slow but steady improvement in contracting for public works construction is evidence that this market is adjusting to the withdrawal of Federal funding (once called the "New Federalism"; now becoming known as the "New Localism"). In constant dollar terms, 1985's first half rate of contracting for transportation-related projects, water and sewer facilities, and other public works advanced 2 percent, extending the three-year recovery which began in 1982. With the support of additional user taxes and a greater degree of local government participation, the current level of public works construction has climbed back to within 5 percent of its pre-1980 strength.

Highways/Bridges: Once the backlog of Interstate work that was delayed by last year's ICE (the Interstate Cost Estimate) hassle is reduced, contracting for highways and bridges will be stabilizing at a rate just above $18.5 billion for the balance of the year. For 1985 as a whole, this means a gain of 4 percent in constant dollars, 9 percent in current dollars.

Water Resources: The budgets of the two Federal agencies that are responsible for most of the nation's water resource development are giving conflicting signals in 1985. Increased outlays by the Bureau of Reclamation are currently more than offsetting cutbacks in the Corps of Engineers' construction programs for dams, reservoirs, and river/harbor development. As a consequence, this year's contracting will be up 5 percent in current dollars (but unchanged from last year's constant dollar value).

Sewer/Waste Disposal: A higher required rate of local government participation in EPA's construction grant program (45 percent since last October vs. the previous 25 percent) is temporarily sustaining total contracting for waste water treatment facilities despite Federal budget cuts. In 1985, current dollar contract value will be up 7 percent, 3 percent of it "real."

Total Public Works Construction: Although next year's proposed "budget freeze" gives reason to doubt that the recovery of public works construction can continue much longer, 1985's contracting is headed for a 3 percent gain in constant dollar value. A modest 4 percent rate of inflation will boost current dollar contracting 7 percent to $35.7 billion.

Beware 1986

Midway through 1985, falling interest rates are breathing new life into the building market. This year's newly started construction, now estimated at $222 billion, will exceed 1984's total by 6 percent as the construction sector rounds another cyclical peak.

By 1986, conditions will be changing. Tax reform threatens to curtail commercial building. The proposed reduction of the Federal deficit could mean deeper cuts for all publicly funded construction. Interest rates will not decline indefinitely. Meanwhile, the benefits of lower interest rates easily outweigh any or all of the mounting threats to the continued prosperity of the construction industry.

October's *Outlook* will be the appropriate time and place to assess next year's risks. For now it is enough to appreciate the bonus of an uncommon late-cycle revival.

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